Congressional Testimony
Mr. Edward J. Nicoll
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Instinet Group Incorporated

Before the House Financial Services Committee
Subcommittee on Capital Markets, Insurance and Government Sponsored Entities
October 30, 2003

Mr. Chairman, Ranking Member, Members of the Subcommittee, thank you for inviting me to testify today on the issue of how to reform our market structure.

My name is Ed Nicoll and I am the Chief Executive Officer of Instinet Group. While Instinet exclusively serves financial institutions such as broker dealers, banks, mutual funds, retirement funds, hedge funds, and the like, I have also had extensive experience serving retail investors as the former CEO of Datek Online, and as the co-founder and President of Waterhouse Investor Services. Both of these companies served millions of retail investors nationwide.

Instinet, through its affiliates, is the largest global electronic agency securities broker. Our services enable buyers and sellers worldwide to trade anonymously and efficiently and, whenever possible, directly with each other. This "cutting out of the middle man" or more properly, eliminating unnecessary intermediation, lowers transaction costs by improving the quality of the trades and lowering commission costs.

Through our electronic platforms, our customers can access over 40 securities markets throughout the world, including NASDAQ, the NYSE and stock exchanges in Frankfurt, Hong Kong, London, Paris, Sydney, Tokyo, Toronto and Zurich. We act solely as an agent for our customers and do not trade securities for our own account or maintain inventories of securities for sale.

While we have successfully leveraged these assets and services in the U.S. over-the-counter market (where we have the largest combined OTC liquidity pool), we have not been equally successful competing for listed trading due to regulatory barriers. All investors would greatly benefit from increased competition and openness in the listed marketplace.

Let's examine why we're in this situation and what we can do to strengthen our markets.

We are a nation of investors. A majority of Americans participate in equity markets by purchasing stocks or mutual funds either directly or through a retirement plan. In many ways, our fortunes as a nation rise and fall with the strength and integrity of our equity markets.

But recent controversies have shaken consumer confidence in the listed marketplace. This crisis is party due to individual misjudgment and poor governance, but the heart of the problem is the structure of the market – specifically, the outdated barriers that protect the NYSE from competition. These barriers increase the cost of trading equities and, over time and many millions of transactions, erode the returns on our investments.

What are these barriers?

The SEC approved the Intermarket Trading System's so-called "trade through" rule in the 1970s to protect consumers who did not have access to all market information.

To understand this rule, think of the battle between Macy's and Gimble's in the movie, Miracle on 34th Street. In that famous movie, Macy's sent its customers to its competitors if its book of competitors' advertisements listed better prices. Seems innocuous enough. It won Macy's customer praise.

But what if it turned out that those ads were wrong, or outdated, and in fact the best deal had been at Macy's all along. Customers would hardly be happy that they had spent time, effort or even money shopping for the "better" deal only to find out it did not exist. Worse while they shopped around, the item may even have sold out at Macy's. Suddenly, being told to go look for the rumored bargain seems like a much riskier plan.

This is similar to what the "trade-through" rule does today. It requires an order to be shipped to a lower-priced market even at the cost of certainty of execution or speed of execution. It forces consumers to risk losing the best certain price so that they can seek a "potentially better" price. It is worth noting that there is no "trade-though" requirement for NASDAQ- listed stocks, and I have seen few complaints from those trading in Microsoft or Dell that they are not getting the price they "deserve."

Now some have argued that there is a trade-off here: that investors can get either the lowest price or the fastest transaction but not both. This is simply not true.

This argument ignores hidden costs, such as the possibility that you will not receive an execution at all, or that you will receive the execution at a price inferior to the one the NYSE is currently quoting. If investors knew with certainty that they were definitely going to get a better price in 30 seconds, and that the market would not move away from them in the interim, they would always accept the delay in execution. The problem is that there is only the possibility of receiving a better price. If there is only a possibility, what should an investor do?

The answer is: "It depends on the investor."

There is nothing novel about the concept of opportunity cost, or the trade-off between certainty and risk. It arises in many aspects of our life. For example, imagine you are selling your house and you receive two offers. The first offer is for $100,000 cash. The second offer is for $105,000 but is contingent on the buyer selling his house and obtaining financing. Which offer do you take? It depends. If you are in no hurry to sell, maybe you wait. If, on the other hand, you need to sell your house as fast as possible to purchase another house you have your eye on, perhaps you take the cash now.

Just as there is no "right" answer for every home seller, there is no right answer for every buyer or seller of securities. But the trade-through rule assumes there is one right answer for everyone. If it were applied to our home-selling example, it would force you to accept the $105,000 offer. But if it turned out that the person that offered you $105,000 could not obtain financing, and you ended up selling your house for $90,000 thereafter, you would not be comforted to know that the rule was there for your protection. This is just another situation when you may miss out on the <u>real</u> "best" price while seeking an elusive "better" price.

We should know, almost by definition, that there is something wrong with the trade-through rule by design. Think about it this way – <u>why do we need a rule requiring investors to always try to obtain the best price?</u> If it appears that investors are not consistently attempting to obtain the best price, maybe it is because our conception of "best price" is wrong.

In fact, a recent study by Greenwich Custom Research – and I ask permission to include a copy of the study in the record – asked 103 institutions that collectively manage over $2.5 million in assets what they want when they conduct a trade. Their top answer: low market impact. Anonymity, price improvement and certainty of execution followed. It is interesting to note that the current definition of "best" price was only one of these four factors.

I am also often asked if getting a worse price ever really happens? Do people ever really lose out? We have an answer based on quantitative evidence.

This past spring, Instinet conducted a test to see why investors were ignoring "better" prices advertised by the American Stock Exchange ("AMEX") when trading the three exchange-traded funds ("ETFs") based on the Nasdaq-100 Trust ("QQQ"), the S&P 500 ("SPY"), and the Dow Jones Industrial Average ("DIA") that the SEC has temporarily exempted from the full effect of the "trade through" rule. To answer this question, we put together a relatively simple methodology. Every time a member of the Pacific Exchange ("PCX") elected to display a bid or offer and ignore a better-advertised price on the AMEX, we sent an order to the AMEX to see what would have happened if the PCX member had, instead, sent the order to the AMEX.

What we found was that the PCX member would have received an execution just 54% of the time. Further, it would have taken, on average, approximately 19 seconds to receive an execution. Of those orders that were cancelled after not receiving an execution in 30 seconds, it took an average of another 13 seconds to receive the cancellation. That means that nearly half the time, an investor that sent an order to the AMEX in compliance with the trade-through rule would have had to start the entire process all over again 43 seconds later.

It seems to me that, given this data, it is very rational for an investor to avoid the hidden costs associated with sending an order to the AMEX. And there is no reason to believe these results are unique to the AMEX or these three ETFs. Any time there is market volatility or heavy trading volumes, whether it is for stocks trading on the NYSE or AMEX, I would expect the same results.

I have included a full copy of our study with my testimony as part of my paper titled, "What's The Best Price?" I ask that it also be included in the record.

Now we can see that these old rules are reducing competition, increasing transaction costs and hurting investors.

But how will changing these rules improve the entire system to the benefit of all investors and participants?

Well, we have been here before and have a perfect "case study" to review.

Prior to 1997, investors trading NASDAQ-listed stocks had no choice of trading venue – all orders were sent to a NASDAQ dealer for execution. Dealers effectively had a monopoly for setting the prices of NASDAQ stocks. The result: an investigation by the Justice Department and findings of fraud, price fixing and collusion by NASDAQ dealers. At the time, the SEC wisely refrained from micromanaging a remedy.

Instead, the SEC opened the NASDAQ marketplace to competition and restored the integrity of the regulatory process. Specifically, the SEC created a regulatory opening for a new sort of competitor: a fully electronic market that could compete with dealers in setting the prices at which NASDAQ-listed stocks were bought and sold. Rather than employing dealers to act as middlemen on every transaction, these all-electronic markets allow investor orders to interact directly. Investors may well have saved billions of dollars from the resulting lower transaction costs produced by this competition.

In addition to introducing competition, the SEC also required NASDAQ to separate its regulatory function from its business operations – eventually forcing NASDAQ to outsource its regulatory functions to the NASD, a non-profit organization.

Today, we see the NYSE confronting many of the same issues – largely stemming, once again, from a lack of competition. As was the case with the NASDAQ dealer, the NYSE specialist effectively controls the entire price discovery process for every security traded on the NYSE. Further, due to the current regulatory structure conceived 25 years ago when manual, floor-based exchanges predominated, new electronic marketplaces like Instinet's two ECNs and NASDAQ are effectively prevented from competing with the NYSE specialist.

So how do we modernize our markets and introduce competition?

We must begin with regulatory reform that knocks down the barriers to competition in the listed environment: specifically, the rules and regulations governing the Intermarket Trading System, particularly the trade-through rule. As I've discussed, these rules undermine the trading benefits that electronic markets offer to investors, stifle transparency, widen spreads, increase transaction costs and most importantly, protect the NYSE monopoly.

In today's technologically advanced marketplace, the definition of best price must extend beyond best "advertised" price and include factors such as speed, neutrality, anonymity and the certainty of making the trade. Our goal should be to level the playing field and give investors the benefits of the narrower spreads and lower transaction costs produced through competition.

Moreover, the NYSE should also be required, as NASDAQ was a few years ago, to separate its regulatory function from its business interests. Regulation is a duty owed to the public and must be separate from the profit motive of a market and its members.

In addition to looking at the 1997 changes in the NASDAQ, we can examine the SEC's own recent actions to see what impact modernizing our regulatory structure might have.

As has been previously mentioned, in 2002 the SEC temporarily eased the "trade through" rule on three ETFs, including the QQQ. These can be traded without the "trade through" requirement so long as they are executed within a *de minimis* range of three cents of the best price advertised on an exchange. Investors seem to have appreciated the added flexibility and choice they now have on these three ETFs – the QQQ is now the single most actively traded security in the entire U.S. marketplace. It's time to expand this reform by eliminating the rule on all listed securities.

Chairman Baker indicated at your hearing earlier this month that you would like specific proposals, and I have attached the White Paper that Instinet submitted to the SEC Market Structure Hearings last fall to my testimony, as well.

Some market participants have indicated that they want regulators to take action on other issues such as fragmentation, so-called regulatory arbitrage, access fees, and locked and crossed markets. But are these concerns really that troubling?

These issues are based upon an unstated and unproven theory that there is a trade-off between order competition and market competition – between centralization and fragmentation. This theory holds that, as the number of markets increase, fragmentation increases, undermining the overall quality of the markets. This theory haunts every market structure issue we're debating today. Just this summer, SEC Chairman Donaldson framed the market structure debate by asking this key question: "What are the best models to achieve the proper balance between competition and fragmentation?"

But what if there is no trade-off between competition and fragmentation? To consider this matter, we must carefully examine what fragmentation is, how it is measured, and precisely why we think it undermines our markets and harms investors. I would suggest an alternative theory that embraces competition, and denies that harmful fragmentation must accompany it.

According to the "single market versus multiple markets" trade-off theory, as the number of markets trading the same security increases, interaction between orders decreases, causing harmful fragmentation. The SEC articulated this perspective in commenting on NYSE's Rule 390, observing that:

> "… the existence of multiple market centers competing for order flow in the same security may isolate orders and hence reduce the opportunity for interaction of all buying and selling interest in that security. This may reduce competition *on price*, which is one of the most important benefits of greater interaction of buying and selling interest in an individual security."

The SEC has historically expressed concern that the existence of multiple markets ultimately degrades overall market quality. This logic could lead us to believe that one centralized market is the answer to all our market structure problems. To be sure, if centralization were deemed to best serve the marketplace, the best thing to do would be to close every market except for one.

If the committee and SEC are ready to take that step, I'll be glad to submit Instinet's application for the job.

I don't believe, however, that anyone is comfortable with shutting down all markets save one, or with the notion of eliminating competition between markets. Moreover, there are fundamental problems with the idea of a centralized market. First, one market cannot adequately serve the diverse needs of every type of investor. Second, with a centralized market there would be no competition between markets, raising transaction costs and inhibiting innovation. The costs of such a drastic step would far exceed the benefits. And I do not believe that it would even solve the "problem." It is worth noting that the totality of information available in the electronic markets is easily exchanged among the various market sites, while the ideas and wishes of actual people on the floor are not so easily discerned. I would argue that this actually makes information across the electronic medium less fragmented than the information available on the floor of a manual exchange. When the government promotes fair access and requires a duty to display information, it eliminates the harmful effects of fragmentation and promotes competition.

For good reasons, then, the policy decisions since the creation of the National Market System reflect a strong preference in favor of competition. Given this preference for multiple markets to compete, there has been a long running and never ending effort to balance fragmentation and competition.

It's time to call off this balancing act. It is impossible for policymakers to objectively measure whether there is too much or too little competition. In the absence of an objective measure of where the appropriate balance is struck, critical market structure issues are resolved based on subjective judgments – which then get enshrined in regulatory regimes – rather than by the marketplace itself.

One of your witnesses put it well during Q & A at your hearing earlier this month: "Fragmentation is just another word for Competition."

In Conclusion

Congress set out two principles in your 1975 market reform legislation that I believe should still be considered when the SEC and others talk about market structure reforms: the National Market System must not favor any particular market or market structure, and it should foster competition between markets.

Over the years, the NYSE has done a remarkable job of building its brand and projecting the image that it sits at the heart of American capitalism. There is no doubt that the NYSE has played a critical role in the development of our markets and our nation's economy. Indeed, I think if you asked most Americans they would tell you that the NYSE is a governmental institution, not a private business, so embedded has it become within our culture.

And that may be the very problem. The decades of protection – some of it due to regulatory barriers and some of it due to cultural insulation – have walled it off from scrutiny and overhaul. Until now.

The current crisis at the NYSE, the ongoing specialist investigation, and the corporate governance issues all highlight the long overdue need to undertake a fundamental examination of whether the NYSE and the regulatory structure erected around the trading of listed securities deliver to investors the fairest, most efficient market possible.

Fairness and efficiency are not mere platitudes. Fair and efficient markets are critical to investors because they foster price discovery, which leads to narrower spreads and lower transaction costs for investors. All of us directly benefit from fair and efficient markets. Efficiency means that stock prices instantaneously reflect all market information, ensuring that investors receive the best, most accurate price. Fairness means no market participant has any unnecessary advantages, ensuring that investors will participate in the market.

We need to take advantage of this opportunity for needed modernization in our National Market System. The reforms and proposals I have discussed today would not eliminate the NYSE model – or even the specialists. The NYSE will continue to be free to pursue the model of its choice. But for really the first time, that model will be tested by competition.

Competition will bring choice to investors and market participants alike. It will bring greater accountability and transparency as investors are free to move their market activities to marketplaces they trust – and thus transparency and related issues will become competitive issues as well.

But competition cannot exist in a system still relying on outdated rules that do not take modern technology and greater information availability into account. The regulation of U.S. market structure needs to evolve if the U.S. markets are truly going to remain the best in the world.

Thank you again for the opportunity to testify before the Subcommittee and I would be happy to answer any questions.

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This document may be deemed to include forward-looking statements relating to Instinet. Certain important factors that could cause actual results to differ materially from those disclosed in such forward-looking statements are included in the Instinet Annual Report Form 10-K dated for the period ended December 31, 2002 and other documents filed with the SEC and available on the Company's web site at www.InstinetGroup.com.

Additional Materials To Be Included with the Testimony of Mr. Edward J. Nicoll CEO Instinet Group, Incorporated

1. "What do Institutional Investors Want in a Securities Trading System" Research Report by Greenwich Custom Research, October 21, 2003.

2. "What's the Best Price? Execution quality includes speed and risk." Article in *Security Industry News* by Mr. Edward Nicoll, March 24, 2003.

3. "Modernizing the National Market System" White Paper submitted by Instinet Group at the Securities and Exchange Commission's Market Structure Hearings, October 29 – November 12, 2002.

Draft

What do Institutional Investors Want in a Securities Trading System?

American Enterprise Institute

October 21, 2003

GREENWICH℠ CUSTOM RESEARCH

A Research Report Prepared for: INSTINET

Respondent Profile

- Interviews conducted September 2 – September 19, 2003.
- Respondents include traders at 103 institutions collectively managing over $2.5 trillion in assets (an average of $25 billion).
- Traders represent multiple investment styles, but predominantly active growth and value management.
- On average, two-thirds of volume in exchange-listed stocks.

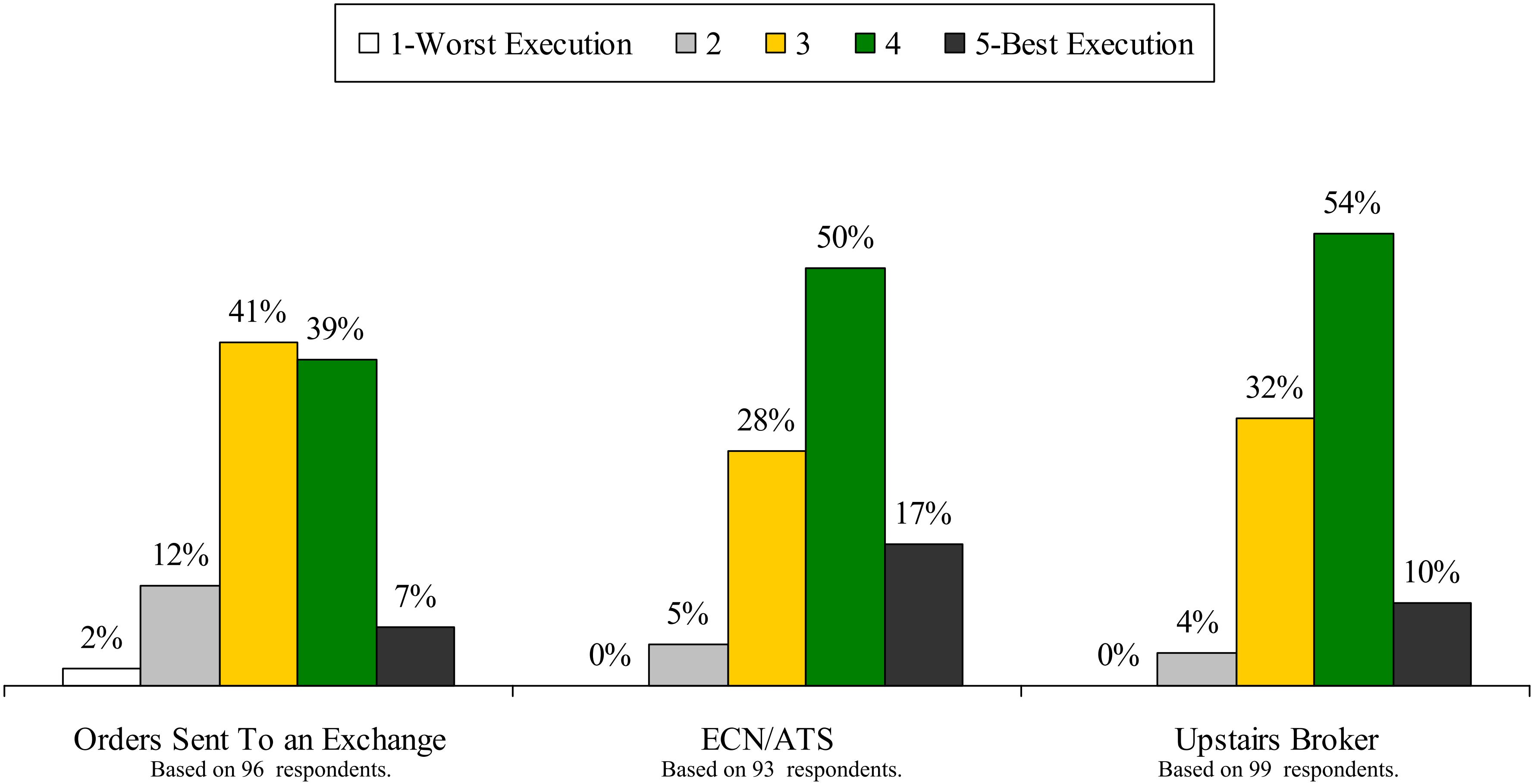
Top-line Findings

- Low market impact, anonymity, price improvement and certainty of execution are all important requirements when executing orders in listed stocks.
- ECNs hold a clear advantage in delivering anonymity and are cited three times more often than an exchange as likely to deliver low market impact (and twice as often as an upstairs broker). Exchanges and brokers hold a modest advantage over ECNs on certainty.
- Over three quarters of traders consider proprietary trading by specialists a conflict of interest. Two-thirds of traders do not think NYSE specialists or NASDAQ market makers add value in trading large liquid stocks.
- Nearly half of respondents would prefer to trade more off the exchange floor. The most common reason: mistrust of the specialists. Other reasons include lack of visible liquidity and order depth, insufficient anonymity, excessive market impact and the need to break up orders.

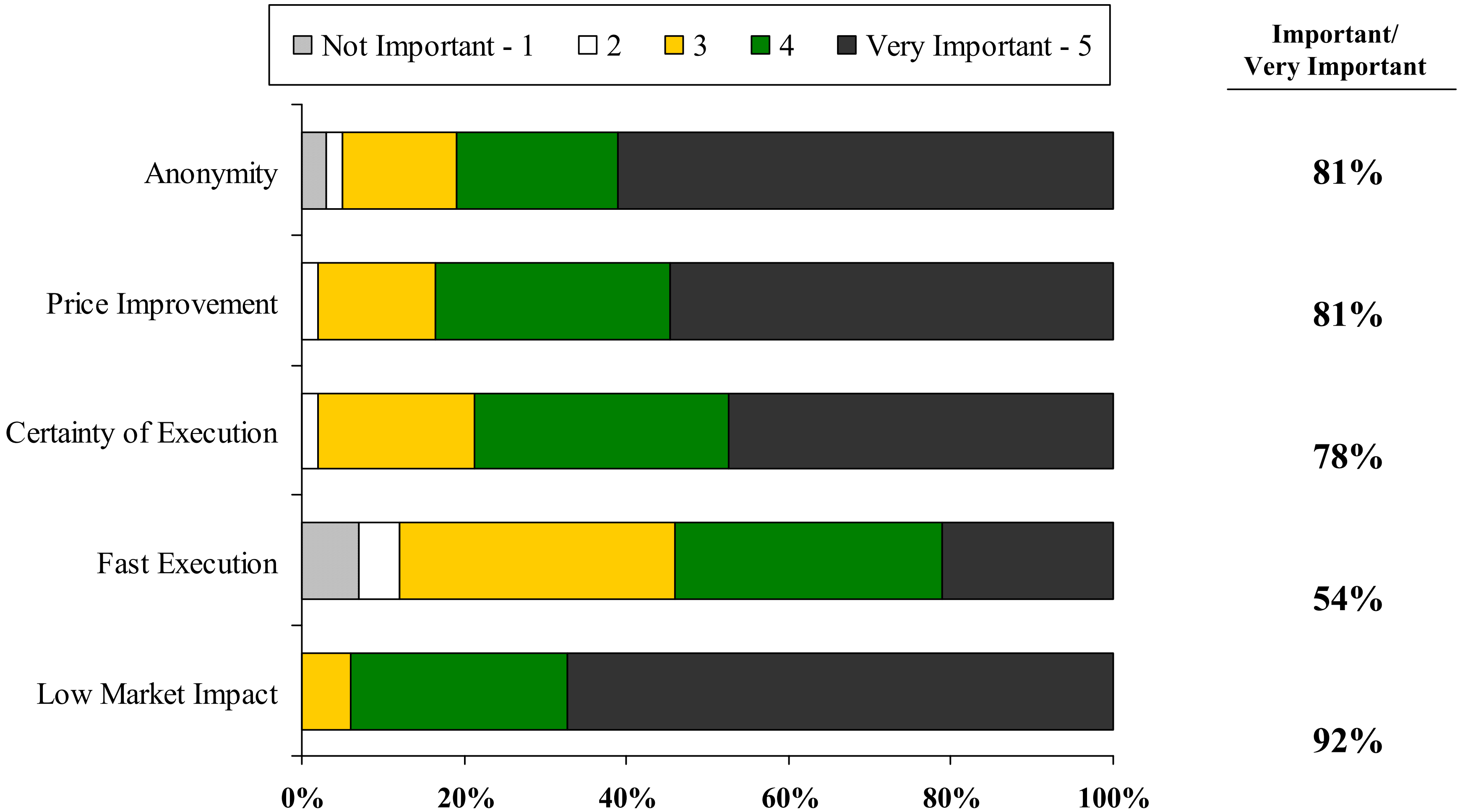
Top-line Findings (continued)

- Among those who would not prefer to move volume off the exchange floor the most frequently cited reasons are the perceived benefits of centralization and the, “human touch”.
- A majority of traders do not see multiple competing venues as a negative.
- Institutions would like to see changes in the listed market — in addition to not allowing specialists to compete with customers, support is expressed for a liquid electronic market in listed stocks with a real time order book and an integrated quote display.

Quality of Listed Execution By Venue

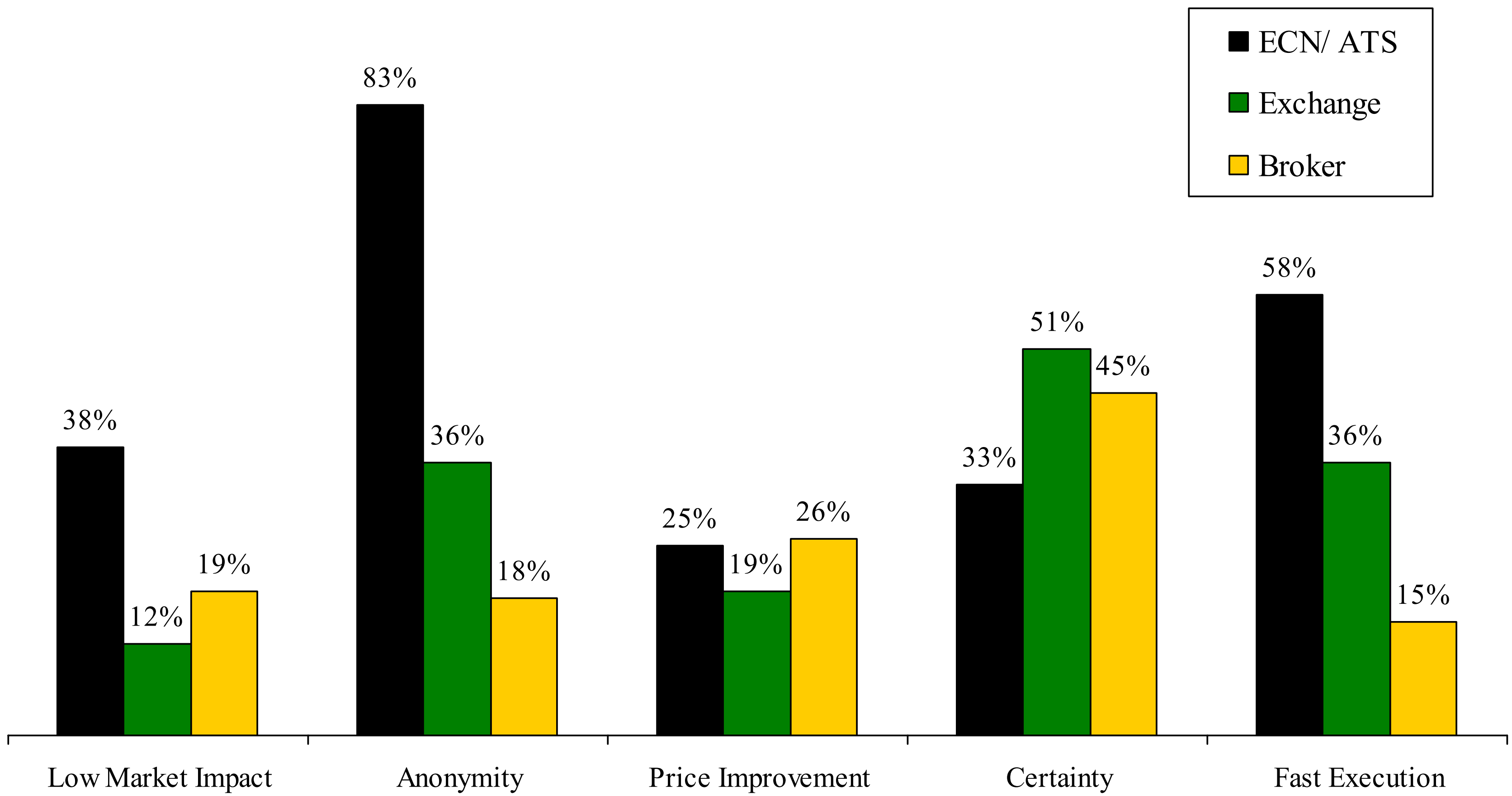


Importance of Attributes When Executing Orders in Listed Stocks



Note: Based on 103 respondents.

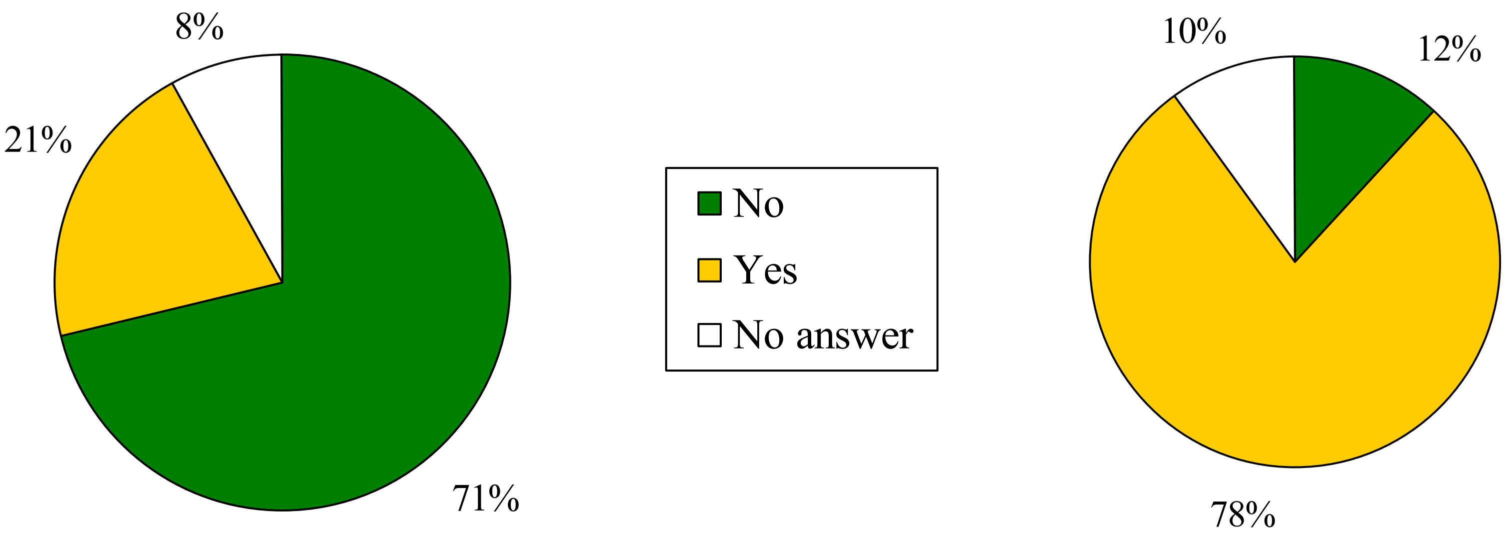
High Probability of Achieving Objectives by Venue



Views On Specialists

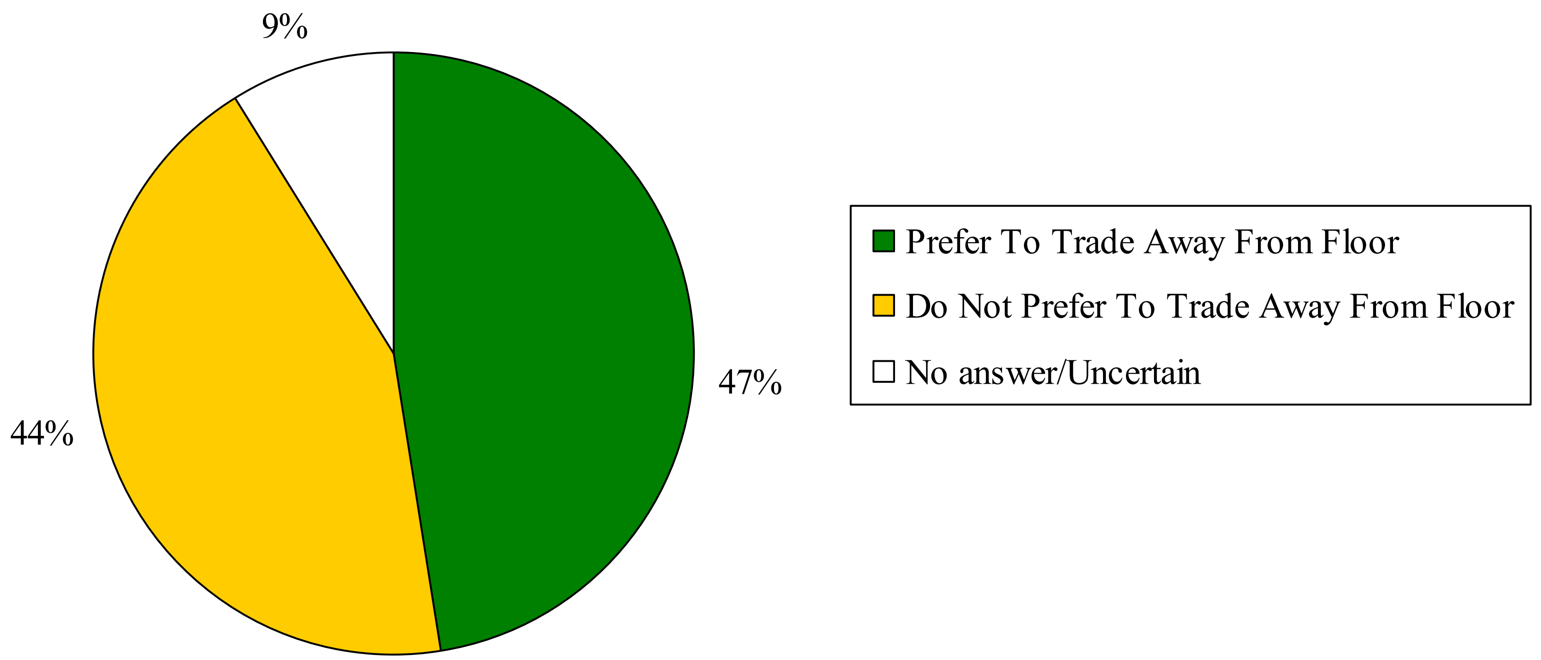
Do Specialists and market makers still add value in highly liquid stocks, such as IBM or Intel?

Does the Specialist's ability to trade on a proprietary basis constitute a conflict of interest?



Note: Based on 103 respondents.

Would You Prefer to Trade More Volume Away From an Exchange Floor?



Note: Based on 103 respondents.

Why Traders Prefer to Trade Away From an Exchange Floor

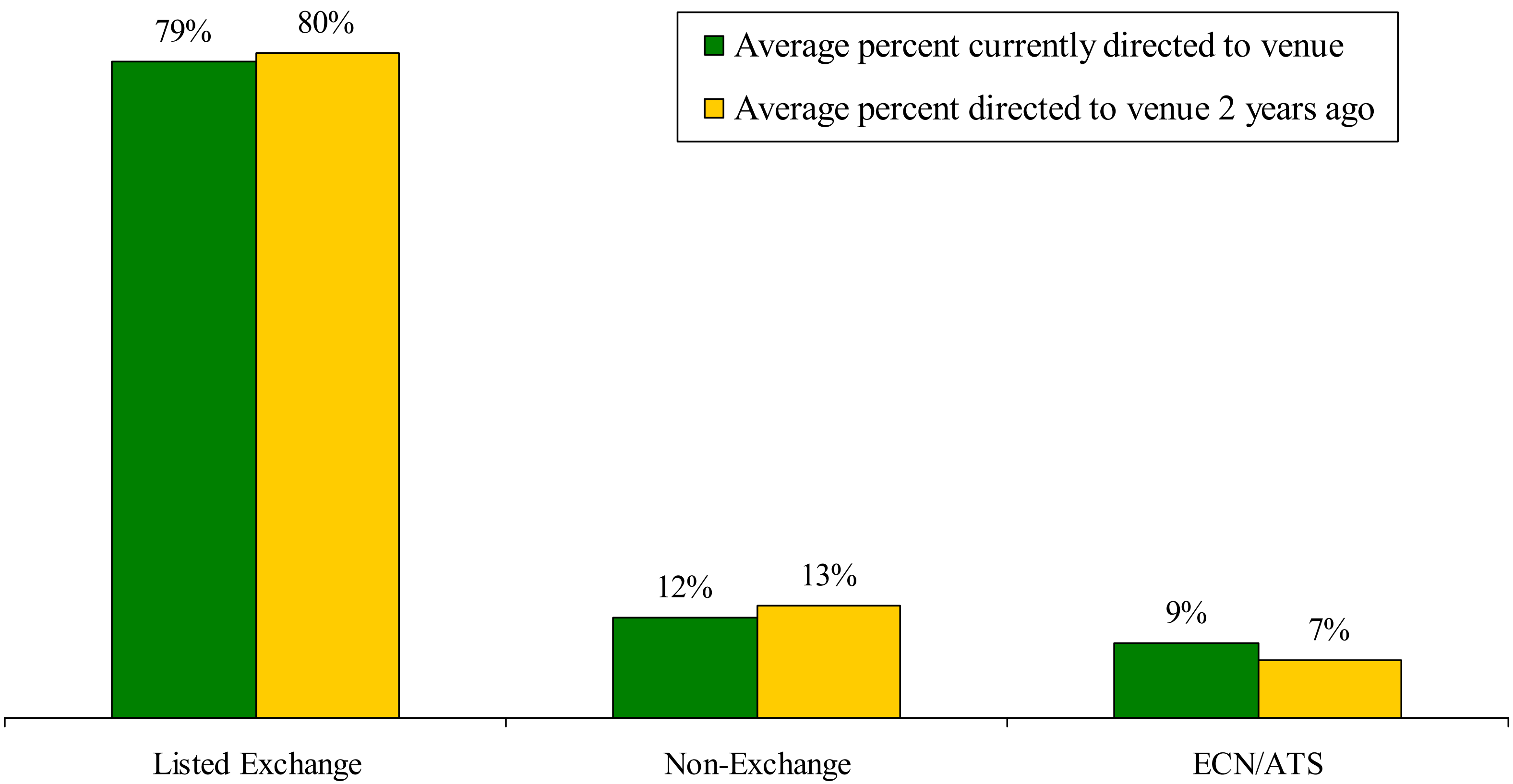
"The specialist is a well funded competitor."

"The primary problem with specialists is pennying and lack of visible liquidity…"

"Liquidity is drying up and I have to go where the liquidity is."

"There are too many intermediaries who don't have my best interest at heart."

Exchange-listed Volume Direction



Why Traders Do Not Prefer to Trade Away From an Exchange Floor

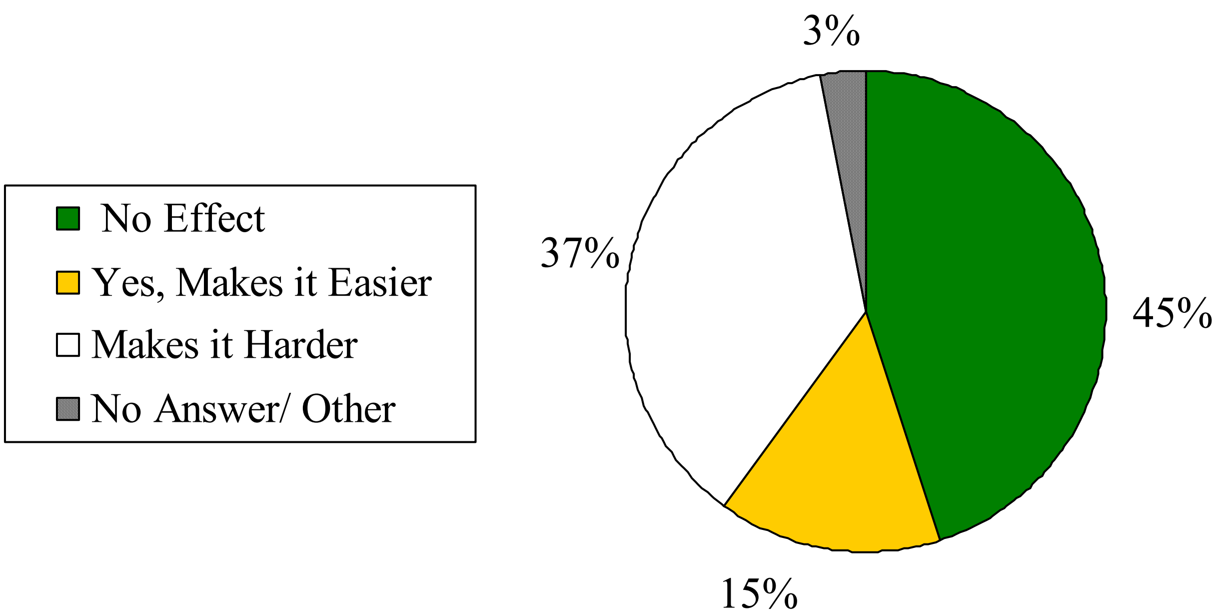
"Central location makes it faster for buyers and sellers to meet."

"On the floor there is more interaction, which provides a better chance for price improvement."

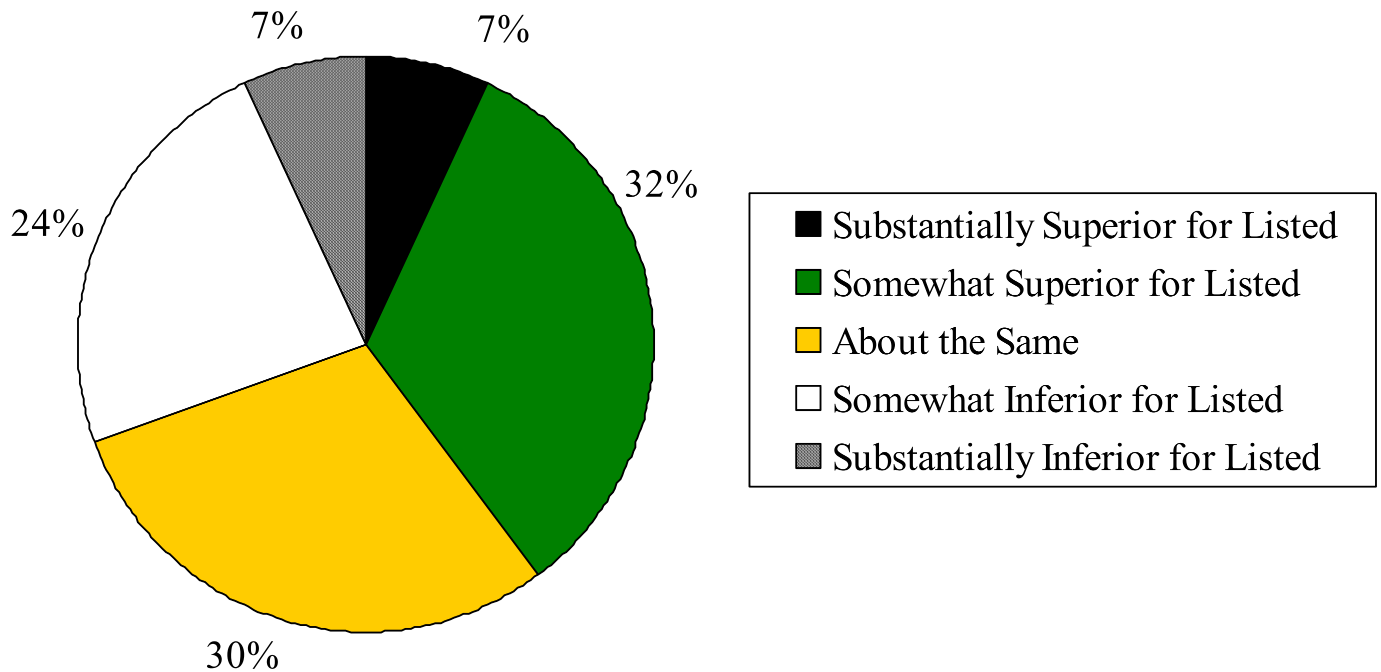
"I don't like fragmentation of the market. I want to see all the players in one place."

"I prefer to deal with people, there is more control."

Do Multiple Competing Venues Affect Traders' Ability to Achieve Best Execution?

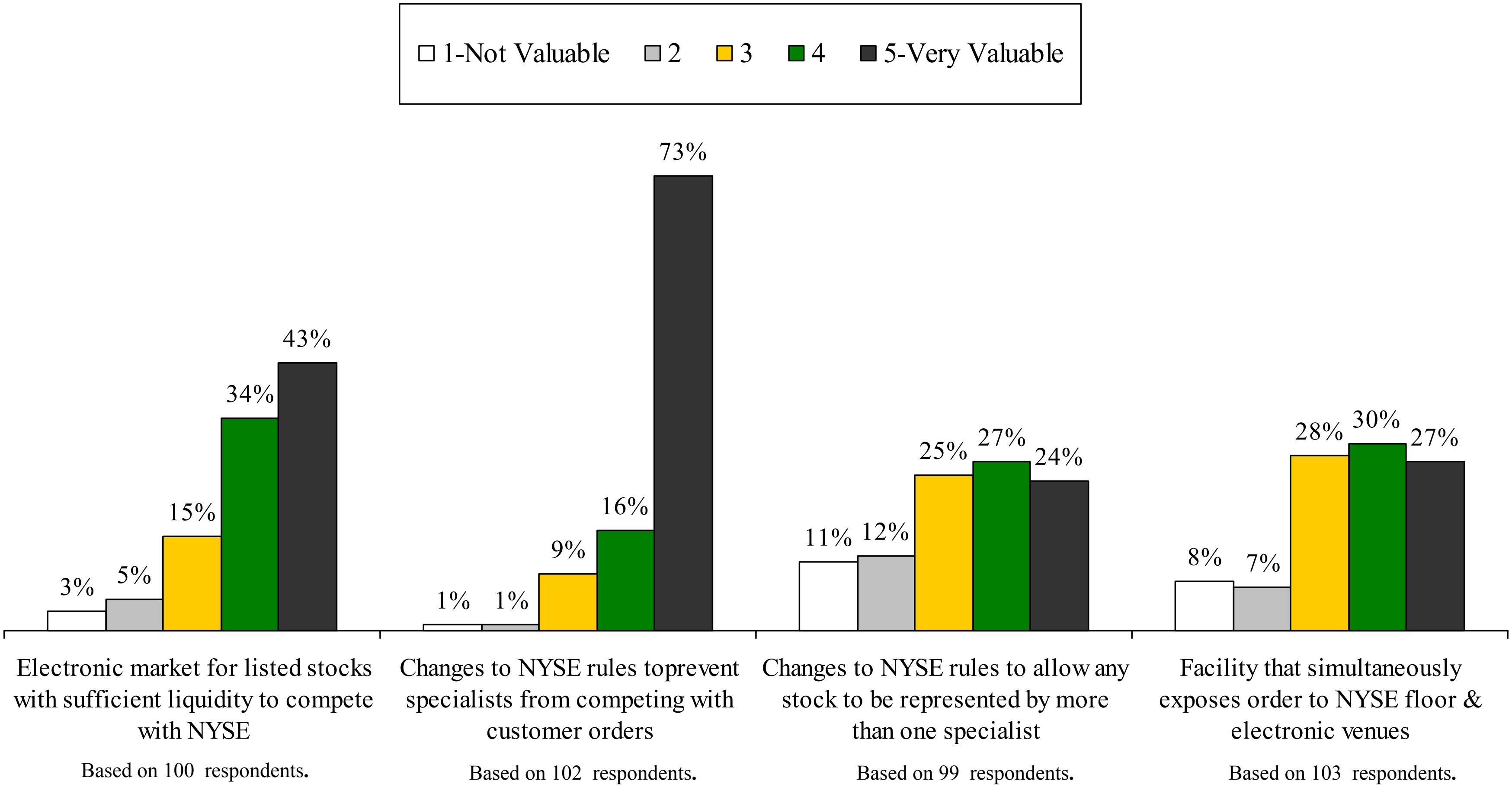


Overall Quality of Execution Between Listed and NASDAQ Stocks

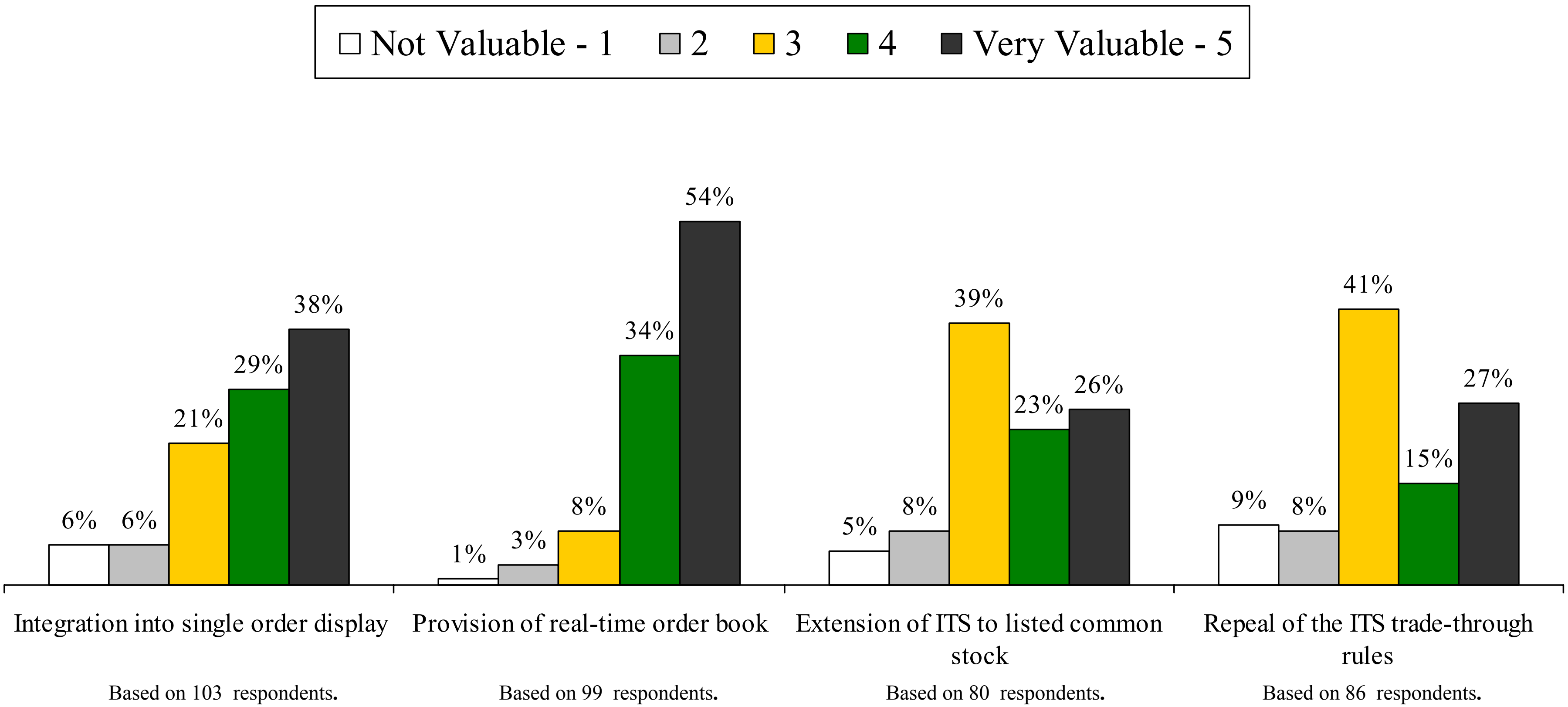


Note: Based on 103 respondents.

Value of Various Trade Execution Changes and Options



Value of Various Trade Execution Changes and Options



What's the Best Price?

Execution quality includes speed and risk.

By Edward Nicoll
CEO, Instinet Group Incorporated

A version of this piece ran in the March 24, 2003 issue of Securities Industry News*.*

When making a purchase or sale, everyone wants to get the best price available. Yet determining the "best price" is a unique exercise for everyone.

Consider, for instance, a decision to sell your house, and assume that you receive two offers to buy the house. The first offer is for $205,000 but is contingent on the purchaser obtaining a mortgage. As a result, the transaction is not likely to close for 2 months if at all. The second offer is for $200,000 but is all cash and the purchaser can close within two weeks. Which deal is better? It depends in large part on your risk profile. If you just want the highest price possible and are not concerned about time delays or the possibility of the deal not closing, you may prefer to accept the $205,000 offer. On the other hand, if you want to sell the house immediately and want to eliminate the market risk associated with the deal not closing (remember, the house may only be worth $195,000 in 2 months) then you may prefer the $200,000 all cash offer. One thing is clear: there is no "right" answer for every person.

While investors selling a house have a choice as to which offer to accept based on their own risk profile, investors do not have the same choice when buying or selling stocks. Specifically, the regulations governing the trading of stocks listed on the New York Stock Exchange and the American Stock Exchange ("Amex") require every investor to always attempt to obtain the best advertised price regardless of all other considerations. While it seems to make sense that an investor should only receive the best price, the definition of the "best price" is not uniform for all investors. "Best price" is not a one-dimensional concept that only includes the explicit cost of closing the transaction. It also includes factors such as market risk and opportunity cost. In the house analogy above, market risk (i.e. the risk that the price of housing will change in 2 months) and opportunity costs (i.e. the risk that after 2 months your offer is rejected and you will have lost the opportunity to obtain a better price in the interim) are two major considerations in determining the "best price." They simply cannot be ignored.

Instinet recently conducted an internal study to demonstrate the risk associated with always accessing the best-advertised price. The study was of trading in three exchange- traded funds listed on the Amex based on the NASDAQ-100 Index ("QQQ"), the S&P 500 ("SPY") and the Dow Jones Industrial Average ("DIA"). The SEC has temporarily exempted these three funds from the general rule that investors always must access the best-advertised price. Instinet specifically identified situations where an investor elected to trade on the Pacific Exchange ("PCX") (an all-electronic market providing immediate executions) at a price inferior to that displayed by the Amex (a traditional floor-based market that takes many seconds to process an order).

Whenever an investor elected to display an order on the PCX even though a "better" price was advertised on the Amex, Instinet sent the Amex an order to determine what would have happened had the investor which chose the PCX had instead attempted to access the better price advertised on the Amex. Of the 387 orders sent to the

Methodology

ON FEBRUARY 4, 2003, THE FOLLOWING TEST WAS PERFORMED:

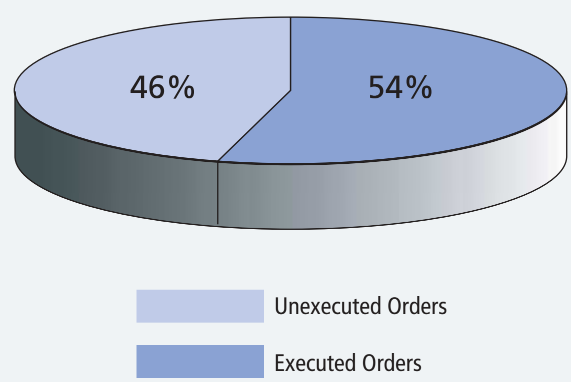
At the moment the quotations of the Pacific Stock Exchange (an all-electronic market) and the American Stock Exchange (a traditional floor-based market) were crossed, a limit order was immediately sent to the AMEX at its then quoted price. A crossed market is a market where the bid exceeds the offer.

Example of a Crossed Market

SECURITY: **QQQ**
HIGHEST BID PRICE: **$25.00**
LOWEST OFFER PRICE: **$24.99**

All orders sent to the AMEX were for 100 shares. The orders were cancelled if no execution was received after 30 seconds. Orders were only sent in the following securities: Nasdaq-100 Tracking Stock ("QQQ"), Standard and Poor's Depositary Receipts ("SPY") and DIAMONDS which is based on the Dow Jones Industrial Average ("DIA"). (As of September 2002, these three ETFs were exempted from certain provisions of the Intermarket Trading System Plan by the Securities and Exchange Commission.)

Percentage of Orders Executed



Overall Results for 2/4/03

DIA, QQQ, AND SPY

Fill/Execution Data

Total Number of Sent Orders	387
Total Number of Executions	210
Overall Fill Percentage	54%
Average Fill Time	00:19.2

Cancellation Data

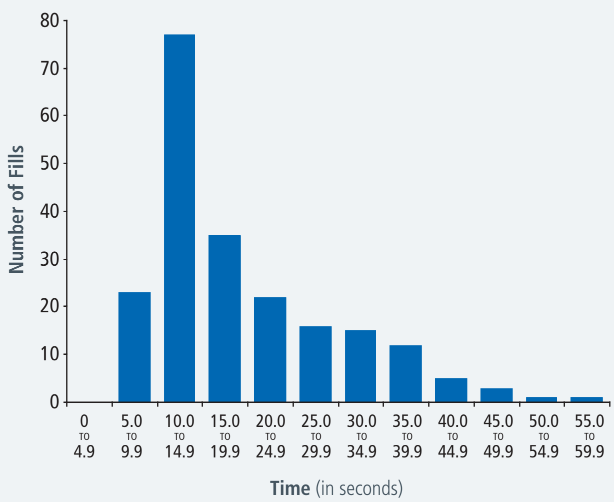
Average Cancellation Time	00:13.2
Total Cancels Sent	211
Total Successful Cancels	177
Successful Cancellation Percentage	84%

Amex, an execution was received only 54% of the time. If an execution was received, it took an average of 19 seconds. Instinet automatically cancelled the order if no execution was received after 30 seconds. In such cases, it took an average of 13 seconds to receive confirmation that the order was, in fact, cancelled.

These results show that investors who ignored the Amex quote were able to eliminate a significant amount of market risk and opportunity cost by not sending an order to the Amex, even though it had the best advertised price. If the investor had sent the order to the Amex, nearly half the time the investor would have waited 43 seconds (i.e. the 30 seconds plus the 13 second average cancel time) to find out he or she did not receive an execution. At that point, the investor would have had to start his or her search all over again. Given the volatility of these securities, it is very likely that the market would have moved significantly in those 43 seconds. Even for the orders that were executed, the market changed prior to receiving an execution report approximately 70% of the time. Is it really better for all investors, regardless of their trading strategy or risk tolerance, to be required to always attempt to access a market with only a 54% chance of receiving an execution and where market risk and opportunity costs are always incurred?

By preventing traders from efficiently limiting their risk in exchange-listed securities, the present regulatory regime also weakens the important role that those traders play in supplying liquidity and narrowing spreads. This increases trading costs for ALL investors.

Execution Times for Orders Sent to AMEX



Perhaps this explains why spreads in exchange-listed securities are now significantly higher than spreads in Nasdaq-listed securities. In Nasdaq-listed securities, there is no regulation requiring every investor to always access the best-advertised price. Investors are free to determine their own risk tolerance.

Every investor has a unique risk tolerance and, therefore, a different definition of what constitutes the "best price." Though a well-intentioned effort to protect investors, the current regulatory structure that is based on a one-dimensional definition of best price needs to be reconsidered. We must find other ways to ensure that investors get the best price without imposing restrictions that may actually reduce execution quality for all investors.

Individual Stock Data

DIA Fill/Execution Data

Total Number of New Orders	131
Total Number of Executions	80
DIA Fill Percentage	61%
Average Fill Time	00:18.6

DIA Cancellation Data

Average Cancellation Time	00:11.3
Total Cancels Sent Out	65
Total Successful Cancels	51
Successful Cancellation Percentage	78.5%

QQQ Fill/Execution Data

Total Number of New Orders	119
Total Number of Executions	56
QQQ Fill Percentage	47%
Average Fill Time	00:19.5

QQQ Cancellation Data

Average Cancellation Time	00:14.0
Total Cancels Sent Out	75
Total Successful Cancels	63
Successful Cancellation Percentage	84%

SPY Fill/Execution Data

Total Number of New Orders	137
Total Number of Executions	74
SPY Fill Percentage	54%
Average Fill Time	00:19.6

SPY Cancellation Data

Average Cancellation Time	00:14.0
Total Cancels Sent Out	71
Total Successful Cancels	63
Successful Cancellation Percentage	88.7%

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MODERNIZING THE NATIONAL MARKET SYSTEM

Market Structure Hearings
October 29 – November 12, 2002

Instinet Group Incorporated, which owns and operates the alternative trading systems Instinet RTTS and The Island ECN, Inc., appreciates the opportunity to participate in the Commission's market structure hearings. For over thirty years, Instinet has served the needs of its customers and investors in an ever-changing marketplace through the application of advanced technology to the trading process and by allowing investors' orders to meet directly without the intervention of a dealer. Instinet's experience brings a unique perspective to many of the issues under discussion at the market structure hearings.

This is an important time period in the evolution of the U.S. equities markets. Spurred by the technological advances of recent years, electronic markets are providing market participants with efficient and innovative trading platforms for Nasdaq-listed securities and are now beginning to provide competition to traditional intermediated markets in exchange-listed securities. The traditional markets are responding to the competitive challenge by incorporating technology to provide their own innovative products and services to market participants.

These developments have taken place in the context of National Market System (NMS) infrastructure and market interaction rules that have remained largely unchanged since their introduction in the late 1970s. The Commission has a tremendous opportunity to modernize the NMS in a manner that ensures that all market types, including electronic agency markets and traditional intermediated markets, are able to compete on a level playing field. This will unleash competition in the listed market, resulting in narrower spreads and improved execution quality for all investors.

Beyond the five NMS principles laid out in Section 11A of the Securities Exchange Act of 1934, the Commission should be guided in its efforts to modernize the NMS by two key principles as set forth by Congress in 1975: the NMS must not favor any particular market or market structure, and it should foster competition between markets.

The National Market System

Competition from electronic markets and changes in the marketplace wrought by technological advances since 1975 have exposed significant stresses in the current NMS. Looking back, it is clear that the two key components of the NMS, the Consolidated Quotation System (CQS) and the Intermarket Trading System (ITS), generally have accomplished their respective missions. The CQS has achieved its goal of ensuring transparency across the equities markets by making available to investors and market participants the best-priced quotations displayed in every participating marketplace. Similarly, ITS has provided a means for addressing concerns regarding fragmented and unlinked markets by ensuring that every market participant has access to the quotes of every market center displayed in CQS.

A. Modernizing the NMS

It has recently become apparent, however, that these systems must be modernized to accommodate advancements in the marketplace, including the growing importance of electronic agency markets in assisting investors to achieve best execution. In particular, while ITS ensures the availability of a default linkage system between market centers, Instinet believes that the rules governing the operation of markets participating in ITS have unintentionally inhibited competition between various market structures. Certain provisions of the ITS Plan governing trade-throughs and locked and crossed markets were adopted solely with traditional, intermediated markets in mind and are not well-suited to accommodating the participation of fully electronic agency markets. Both rules force market participants to make order routing decisions based on quotations that oftentimes misrepresent the price actually available on the market disseminating the quotation.

Consequently, the effect of the trade through and locked and crossed markets rules has been to add time delays and uncertainty to the marketplace as well as undermine the speed and certainty of execution advantages offered by electronic agency markets. The effectiveness and utility of these rules have been further called into question by the Commission's recent finding of widespread non-compliance with the trade-through rule, particularly in active securities such as Exchange Traded Funds ("ETFs"). Although the Commission recently adopted the *de minimis* exemption for certain ETFs in an attempt to address the concerns associated with the trade-through rule, Instinet believes that there is general agreement among a broad spectrum of market participants that a more comprehensive long-term solution is necessary to resolve the fundamental issues associated with the ITS Plan.

B. Benefits of Competition

Fostering competition and modernizing the NMS is not an obscure concern merely important to a narrow segment of the marketplace. A modernized and efficient NMS is critical to fostering the vibrant intermarket competition that Congress believed would provide the opportunity for best execution to all investors. Investors directly benefit from the narrower spreads and lower transaction costs that result from competition and innovation. For example, in Nasdaq-listed securities, electronic agency markets have emerged as the prime source of quotations that narrow bid and ask spreads. Statistics show that ECNs are at or alone at the inside market approximately 70% of the trading day.[1] Moreover, due in large part to the emergence of electronic agency markets, the Commission's execution quality statistics reveal that the average effective and quoted spreads in the Nasdaq-100 securities are significantly lower than effective spreads in the S&P 100 exchange-listed securities.

[1] See Release No. 34-45957, SR-NASD-2002-23 March 17, 2002.

One key reason that electronic agency markets often display the best prices is that they provide market participants with a more efficient mechanism to rapidly represent their trading interest to the marketplace. Users of electronic agency markets can display or cancel orders within milliseconds as compared to several seconds (*e.g.* specialists have up to 30 seconds to represent their best priced limit orders) in traditional intermediated markets. The impact of these delays on spreads (and therefore, the execution prices investors receive) is perhaps best understood through an analogy. Imagine a buyer of a house could only submit a bid that was irrevocable for one year. Given the time delay, buyers would certainly bid lower to take into account the risk of an adverse market move during that one-year period. Time delays of only a few seconds have a similar impact on trading. As a result, to the extent that electronic agency markets effectively eliminate time delays, they enable market participants to enter the best possible price. Retail investors, whose orders are generally internalized by a dealer at the National Best Bid or Offer, directly benefit from the narrower spreads that result from efficient, electronic agency markets.

The challenge before the Commission is to modernize the NMS in a manner that enables electronic agency markets to bring the benefits of narrower spreads and lower transaction costs to investors in exchange-listed securities that they have brought to investors in Nasdaq-listed securities. In particular, by amending certain ITS rules, investors can directly benefit from the quote competition offered by electronic agency markets. As the Commission is well aware, quote competition among the markets trading exchange-listed securities has been almost non-existent, notwithstanding the Commission's efforts to encourage such competition through the NMS.

The importance of providing an efficient all-electronic alternative marketplace in exchange-listed securities was highlighted by the success of Island's marketplace for trading the Nasdaq-100 Tracking Stock known as the "QQQ." Prior to Island, the primary market specialist effectively controlled the market for trading in QQQ. The sudden availability of an efficient, low-cost electronic alternative to the primary market specialist made possible quote competition and trading strategies that were not available before. As a result, hundreds of firms began trading QQQ and competing with the specialist on price, with the result of narrowing spreads and increasing the liquidity in the QQQ marketplace. Trading volumes in the QQQ rose from approximately 30 million shares per day in 2000 to approximately 90 million shares per day in 2001. In fact, QQQ is now the most actively traded security in the world.

C. <u>An Alternative Approach</u>

The above discussion is not meant to suggest that traditional intermediated markets are inferior to electronic agency markets – just that the emergence of electronic agency markets has brought clear benefits to investors and the marketplace alike. Therefore, in modernizing the NMS, the Commission should ensure that the NMS does not favor any particular market structure, thereby preserving the opportunity for continued competition and innovation. Investors that want exposure to the unique price discovery process of a traditional market should be permitted to route orders accordingly, as should investors that value the speed and certainty of execution of an electronic agency market. Instinet envisions a NMS where an investor can view the best prices in every market and access those best prices. NMS rules should not dictate where orders are sent but only mandate transparency of order and trade information and access to market centers on non-discriminatory terms. By pursuing a neutral and open architecture market structure, the Commission will more effectively enhance investors' opportunities to receive best execution of their orders.

Despite the benefits of electronic agency markets in Nasdaq-listed securities, some interested parties remain concerned about the consequences of eliminating provisions specifically adopted with the goal of protecting investors, such as the trade-through rule. These parties believe that the trade-through and quote through rules are necessary to ensure the best execution of retail customer orders. As noted above, however, Instinet believes that these provisions actually work to the detriment of investors by inhibiting efficient trading, widening spreads, and increasing transaction costs. Ultimately, Instinet believes that the "costs" (e.g., negatively impacting inter-market competition and innovation) associated with the trade-through rule outweigh the "benefits." Ensuring best execution of investor orders, the most cited purported benefit of the trade-through rule, can be achieved in other ways that do not also negatively impact other important goals of the NMS such as competition and innovation.

In fact, trading in Nasdaq-listed securities provides a blueprint for how best execution can be assured without a trade-through rule. Markets that serve retail orders in Nasdaq-listed securities currently guarantee executions at the National Best Bid or Offer due to business and regulatory necessities. From a business perspective, the Commission's recent adoption of execution quality statistics and strong emphasis on best execution has served to make all market participants aware of the importance of providing customers with best execution. Providing inferior executions in a transparent environment is a clear invitation to competitors to take away business and investors to move their business elsewhere. From a regulatory perspective, regulators are now able to closely monitor the execution quality of market participants executing customer orders through surveillance reports that routinely alert regulators of transactions effected away from the prevailing market. Regulators perform reviews of these transactions to ensure that they were not for the account of a retail customer. The innovation and competition over the past few years in Nasdaq-listed securities that led to the dramatic improvement in execution quality reflects the benefits of ensuring best execution through means other than a trade-through rule.

In summary, the surest way to maximize the opportunity for best execution for all investors is to create the most efficient market possible. Efficiencies are introduced to the marketplace as a result of innovation spurred by competition. All investors benefit from the narrower spreads and lower transaction costs that result from increasingly efficient markets. To the extent that certain provisions of the NMS inhibit competition and innovation (and, therefore, efficiency), the Commission must consider whether the goal of the particular provision can be better achieved in ways that do not distort competition. In particular, Instinet believes that the trade through and locked and crossed market provisions distort and inhibit competition by dictating how market participants must interact, without regard to the distinct differences between various market types. The goals of the trade-through rule can be achieved with the least amount of market distortion, as is currently the case for Nasdaq-listed securities, by promoting an environment in which competition, regulatory oversight, and disclosure requirements combine to assure that brokers representing retail customer orders (rather than a market center), fulfill their duty of best execution.

What is an Exchange?

Nasdaq's application for registration as a national securities exchange has led the Commission to reconsider the fundamental question of what it means to be an "exchange." Specifically, Nasdaq has proposed to be an exchange without imposing marketwide price-time priority rules on its members, which historically have been considered a central element of "exchange" marketplaces. The Nasdaq exchange application raises serious questions as to whether this historical notion, which is not required by statute, continues to serve the best interests of investors.

Instinet believes that statistical evidence and recent experience suggest that the historical presumption that market centers that require price-time priority between market participants (i.e. traditional *intra*-market price-time priority of exchanges) better serve investors should be revisited. Commission required statistics on execution quality indicate that average effective spreads in the top 100 Nasdaq-listed securities are now lower than those in the top 100 exchange-listed securities, despite the fact that Nasdaq stocks are traded in a decentralized market that does not feature *intra*-market price-time priority. In addition, the decentralized market structure of the over-the-counter marketplace has fostered a variety of business models by giving market participants the flexibility to structure themselves to meet the unique needs of diverse customer groups. Investors trading Nasdaq-listed securities have access to a variety of software packages that allow them to see the entire depth of the market in real-time and electronically route orders to any marketplace within seconds. Electronic agency markets have led the way in providing trading solutions uniquely tailored to the diverse needs of different market participants.

Ironically, such electronic agency markets may never have existed if the NASD were required to enforce price-time priority on the market participants within Nasdaq. Specifically, if an electronic agency market were forced to route orders to the best price displayed within Nasdaq, the speed and certainty of execution advantages of electronic agency markets would have been negated. This is particularly the case since, until recently, Nasdaq market participants had up to 30 seconds to respond to orders. As many investors now strive to save milliseconds, such delays would have had a substantial negative impact on the competitiveness of electronic agency markets and, more importantly, on the quality of the executions available to investors.

Instinet believes that, in the context of the developments of the past few years, the Commission should adopt a policy with respect to registered exchanges that recognizes that there are merits to both price-time priority markets and decentralized markets. Instinet is concerned that a policy that requires exchanges to operate only with price-time priority marketplaces stifles competition to the detriment of investors. Not only does such a policy unnecessarily inhibit the ability of decentralized markets to compete as they have so effectively over the past few years, but such a policy also could preclude the development of altogether different market models that do not fall neatly into either category.

As a result, Instinet supports a policy that would allow every exchange to determine for itself whether it will operate with price-time priority principles, without such principles, or in some other manner entirely. In each such case, the role of the Commission would be to ensure that certain basic standards are met. All markets, for instance, should be required to meet standards for transparency, access, and regulatory oversight. Moreover, if the Commission is concerned that investors and market participants have certain expectations regarding the market structure provided by a market with an "exchange" label, consistent with its role as a disclosure agency, the Commission could require registered exchanges to provide enhanced disclosure as to the order interaction rules in their markets. A flexible approach will best accommodate innovation and ensure the continued competition within our equity markets that has driven their unparalleled efficiency and fairness among the world's markets.

In summary, given the serious questions concerning which market structure provides greater benefits to investors, Instinet believes that the best policy is not to mandate any basic market structure elements across exchanges or otherwise favor any particular market structure over any other. Instead, every market center that is registered as an exchange, including Nasdaq, should be permitted to determine for itself how it wants to operate vis-à-vis intra-market price-time priority.

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